

# The Philippine Economy in the Asian Crisis

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*The Philippines has avoided the worst consequences of a full-scale crisis because it had strong economic fundamentals, including a reformed financial sector at the onset of the regional crisis. This paper gives an account of the response of the Philippines to the baht collapse. The peso was floated shortly after the baht currency crisis. One year later, the Philippine economy was still in relatively good shape, but growth was slowing down and there was concern about the consequences for the Philippines if the contagion spreads beyond Asia. The new Estrada Government stressed the need for further stringent budget cuts. The stock market continued to decline. The liberalization programme was kept in place, inflation remained moderate, and exports continued to show strong growth. However, the economy remains vulnerable if the crisis continues much longer.*

## High Growth Scenario is Cut Short

The Philippine economy was cruising towards a higher plateau of growth activity when the Thai authorities floated the baht on 2 July 1997. For more than a decade the Philippines economy had played the growth laggard in ASEAN. Rising from its own economic crisis that was experienced during that decade and, with the help of successful structural reforms, the Philippine economy began to show credible economic achievements measured by growth, exports, investment, and macroeconomic stability.

The annual growth of the gross national product (GNP) averaged 5% in 1994 and 1995. The growth of gross national product in 1996 was close to 7%. The export growth achieved by the Philippines was the highest in Asia in 1995, at

almost 30% that year, and annual export growth over an extended period up to 1997 averaged around 25%. At US\$25 billion, this scale of exports was still low by "Asian tiger" standards, but the high export growth was announcing the arrival of a new "tiger" economy, and import growth was fuelled by rising investment. The large current account deficit of about 5% of GNP during 1993 to 1997 was viewed as an indication of rising investment and therefore not a cause for alarm.

After one year of crisis, by mid-1998, the situation continued to show the Philippines in relatively good light *vis-à-vis* worse-affected neighbours, but with a substantial slowdown in real output. In 1997, real GNP grew at 5.4%, a result that already factored in the impact of the crisis. At the outset, it was widely believed that

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the impact of the crisis on the Philippines would be minimal. As the crisis evolved and became more prolonged, expectations about the future became more bearish.

The Philippine experience is essentially one of responding to a major currency crisis that led to a contraction of overall demand, with positive growth remaining an element of the situation. In the other countries — particularly in Thailand, Indonesia, and South Korea — the experience was one of systemic crisis in the banking and financial sector, and a major foreign debt exigency resulting in measures that led to a major contraction of output.

### **Economic Fundamentals before the Crisis**

Relatively sound macroeconomic fundamentals underlay the pre-crisis optimism. In 1994, the national government achieved a fiscal surplus. This fiscal performance was sustained for four years in a row. The fiscal surplus of the national government reached almost 1% of GNP in 1994, although this stabilized throughout the period at about one-third of 1% of GNP until 1997. A consolidated fiscal surplus (to include all sources of fiscal operations, including public enterprises) was not attained until 1996 (at one-third of 1% of GNP). The government objective was to sustain a consolidated fiscal surplus to facilitate better management of the growth of public investment.

There was also considerable improvement on the external debt front. The Brady debt deal of 1992 helped a lot. The high external debt burden inherited from the problems of the 1980s was gradually reduced. From a high debt service burden at the height of the 1980s crisis of close to 25% of export earnings, the external debt service ratio fell. By 1994, the debt service burden was 16% of export receipts. And this fell further to just below 10% by 1997, partly as a result of the fast growth of exports.

As real output growth rose, the annual inflation rate was kept low, at 5%, compared with two-digit inflation during the previous decade, a result of the weaker macroeconomic framework. The improvement in the macroeconomic framework

encouraged the government to publicly pronounce a desire to graduate from an IMF programme. Philippine sovereign debt ratings were made by Moody's and Standard & Poor's — the two major investment rating agencies — and the resulting ratings were favourable, although below investment grade still.

The full liberalization of exchange rate transactions including capital movements made the Philippines attractive for capital flows. From 1992 to 1995, net foreign direct investment rose dramatically. More than 80% of capital flows were foreign direct investment. However, portfolio investment capital began to dominate the capital flows thereafter, rising to almost twice the amount of direct investment flows by 1996.<sup>1</sup> The volume of shares transacted during this period more than doubled. The composite index of the Philippine stock exchange (the Phisix) peaked in 1996.

The surge in capital inflows allowed the central bank to build up reserves by participating heavily in the purchase of dollars, in part to build foreign exchange reserves to a level compatible with that of import demand. Traditionally, reserves were kept to a level equal to slightly more than three months of imports. The central bank allowed the nominal exchange rate to remain fixed within a narrow band. In fact, through its actions to encourage the capital flows and its effort to sterilize the monetary impact within the economy, the peso experienced a high rate of real appreciation.

The nominal peso exchange rate kept within the range 25.50 pesos to the U.S. dollar between 1992 to 26.22 pesos to the U.S. dollar in 1996. This policy of almost fixing the nominal exchange rate was largely responsible for the 40% appreciation of the real effective exchange rate.<sup>2</sup> Despite this large appreciation, the export sector performed quite well. The Philippines benefited from the inauguration of highly attractive industrial estate zones in well-established centres with a high level of infrastructure, including the converted Subic Bay freeport area after the departure of the U.S. naval base. These developments had encouraged a high inflow of new investments in the electronics and

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other labour-intensive sectors, partly influenced by very favourable labour force demographics.

### **Initial Contagion Not Severe**

When speculation against the peso became heavy in July 1997, the authorities moved to neutralize the impact by also buying dollars heavily. The central bank had used this tactic in previous episodes of instability. For instance, during the Mexican devaluation in 1995, market confidence returned soon after an initial effort to prop up the peso. The Philippines was not drawn into the Mexican crisis, and at that time, developments in Asia were considered very favourable. This time, the cost of intervention in the currency market ran high. Almost one billion dollars of reserves were used within a few days without any positive results.

The currency crisis led to the floating of the peso. The central bank allowed the peso to move along a wider band than before, thus creating room for adjustment to market changes. The government sought immediate assistance from the IMF. This quick reaction shielded the economy from further loss of confidence in the face of speculative activity. The IMF agreed to extend a US\$1.3 billion aid package. This also effectively put an end to the planned graduation from the IMF programme in the meantime. In contrast, the other countries — Thailand, then South Korea and Indonesia — took much longer to agree on the parameters of their programmes with support from IMF.<sup>3</sup> It was propitious that a programme was already in place with the IMF. The macroeconomic and financial programme had been part of a continuing policy dialogue. There were no major contentious issues that separated the government from the IMF. By acting sooner than the other severely affected countries, the Philippines avoided a more serious crisis from engulfing it at the outset.

Major measures to strengthen the financial sector were undertaken during the second half of the 1980s and the early part of the 1990s, especially in banking. The banking reforms were an important part of the story of how the

Philippines avoided an immediate crisis. Previous efforts to clean the balance sheets of weak banks, and to close bankrupt banks, had helped to reduce the volume of non-performing loans. Poorly managed banks had already been forced to close, or put under surveillance by larger banks. The government financial institutions that were heavily saddled with bad loans were put through a stringent financial restructuring process involving support by the government.

A programme requiring an increase in the minimum capitalization of the banks was implemented. Poorly capitalized and weak banks had to raise additional capital. This encouraged the weak banks to seek mergers with banks that had stronger capital bases and/or find new sources of capital to expand. Eventually, this programme led to the adoption of a strategic partner in the form of a foreign bank. Such strategic partnerships strengthened the management of the banks.

In 1993, the government decided to liberalize the banking system further. Ten additional foreign banks were given licences to operate fully owned branches in domestic banking. This action encouraged competition in domestic banking and strengthened links to world markets. In 1995, the central bank further raised the minimum capital requirements of banks. The build-up of additional capital was staggered in two stages and would be completed by year 2000.<sup>4</sup>

The banking system had relatively strong fundamentals. In 1996, non-performing assets accounted for 3.3% of total assets of the banks, compared to 4.2% in 1994. For commercial banks, in contrast to the whole banking system, the ratio was even stronger, at 2.7%, compared to 3.1% in 1994. The past due loans as a ratio to the total loan portfolio of banks also declined, from 4.7% in 1994 to 3.8% in 1996. For commercial banks, the ratio was even better, and rising from 3.9% to 3.0%. Moreover, the capital adequacy ratio of Philippine banks, at 17%, was close to that found in economies with strong banking systems, such as Hong Kong (17.5%) and Singapore (21.7%). It was higher than those of Thailand (9.6%) and Korea (9%).

Having just emerged from its own previous

economic crisis, the Philippines was entering the early phase of a property boom. Strong demand for construction emanated from the steady growth in demand for housing and for office spaces. The infrastructure programme was given a major lift when a build-operate-transfer (BOT) scheme of investment was allowed and encouraged by the government, ranging from the provision of energy supply, transportation and port projects, and telecommunications. These arrangements brought in private sector participation, including foreign investors. Thus, the boom in the real estate sector simply ran parallel with government infrastructure construction.<sup>5</sup>

A real estate lending survey of 21 banks conducted by the central bank in 1996 found that loans to the real estate sector accounted for only about 10.9% of their total loan portfolio. This ratio appeared relatively low by international standards.<sup>6</sup>

The relatively low exposure to the property sector owed much to the early precautionary measures taken by the central bank. The central bank reduced the collateral basis involving real estate property from 70% of appraised value to 60%. This provided a hedge against further declines in property values. A regulatory limit on bank loans in the property sector was prescribed in order to limit bank loans to a level not exceeding 20% of the bank's portfolio.

### **Impact More Severe in 1998**

The worsening impact of the crisis was also felt in the fiscal sector. Instead of a surplus, it was clear that a deficit loomed unexpectedly. Incoming revenues fell short of planned expenditure, and this was aggravated by the fact that the first crisis year coincided with the campaign for the presidential election in May 1998. The Ramos administration — in its last year in office as the crisis struck — tightened the budget nevertheless, imposing fiscal austerity.

The new Estrada government (which took office on 1 July 1998) stressed even further the need for more stringent budget cuts in response to the contraction in the expected growth target.<sup>7</sup>

The revised projections of real GNP growth were further reduced by more than half of the earlier target, to 2.5%. By the second half of 1998, economic performance had weakened across a spectrum of sectors. The industrial sector, apart from continued electronics export growth, has been hard hit by the downturn of domestic demand and may show slight negative growth. Growth is likely to be further adversely affected by weakness in the agricultural sector due to the long El Nino drought, especially in Mindanao.<sup>8</sup> The labour troubles at the Philippine Airlines, which led to its temporary closure, mirrored the emerging difficulties at the industrial relations front, especially for companies facing severe adjustment issues.

Bank profits have been affected by the rise in bad loans. The proportion of non-performing assets to total loans rose to 9.4% in May 1998, according to the central bank, within prudent bounds, but a cause for concern. A Standard & Poor review of public ratings for eight Philippine banks downgraded them by one notch down in the expectation that their non-performing assets would rise further during the year. In reaction to these ratings, the central bank averred that the bad loan ratio had peaked.

No Philippine commercial bank has gotten into serious financial trouble.<sup>9</sup> Banks have become timid in lending, partly owing to uncertainty about the movement of exchange rates and, consequently, interest rates. Domestic credit has tightened as a consequence. Public sector credit remained stable, so that the squeeze was felt mainly by the private sector. The banking sector remained relatively strong despite the squeeze on its profits.

The Treasury sought to hold interest rates, but this was bound to affect the exchange rate, and this is indeed what seems to have happened. The peso exchange rate depreciated more than the Thai baht. Prior to the crisis, the baht and the peso were in rough parity, but by September 1998 the peso was cheaper.

The stock market has continued the downward spin that began with the regional crisis. The withdrawal of portfolio investment had at once a

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dramatic effect, judging by the drop in the composite stock index of the Philippine Stock Exchange from close to 2,900 index points in July 1997 to 1,450 index points by the end of that year. But the decline was reversed for a while and the index stabilized around 2,250 points until June when the decline accelerated again.

Among the factors that contributed to this decline in the stock market, besides the withdrawal of portfolio capital, was the effect of the imposition of exchange controls in Malaysia on expectations in the region.<sup>10</sup> By mid-September 1998, the Phisix had tumbled to an eight-year low, falling below 1,075 points. Stock market turbulence was expected to continue in the Philippines, as elsewhere.

The property sector has also continued its downturn. Many property companies experienced major drops in profitability ranging from 30% to 70% from the year before. The central bank's efforts to reduce the exposure of the banks to the property sector provided a brake. Credit tightening and a general downturn of demand have caused a slowdown of construction, but major public infrastructure projects (such as the skyway and the metro rail projects) have continued their activity. Metro Manila's skylines continue to change and projects that were caught in mid-stream are still proceeding.

The country's economic fundamentals remain geared towards recovery, once conditions are right on the international front. The budget, although in deficit, is kept under control. The liberalization programme remains in place. Inflation is kept close to 10% for the year. Exports continue to show strong growth. External balance has also improved, having moved into surplus when, in the past, it was always in deficit.

### **Hard Lessons**

The measures adopted to restructure the economy before the crisis of July 1997 had their roots in the earlier crisis of the mid-1980s. Learning from this painful experience, the government improved policies which helped to maintain prudent fiscal management, to promote accountability of the

government, and finally to encourage greater political openness and democracy. The most noteworthy institutional development in the Philippines from 1986 has been in the strengthening of the political institutions that allow for checks and balance between the executive, parliamentary, and judicial branches of the government. This was, of course, the very institutional framework that martial law and subsequent authoritarian rule had interrupted for almost fifteen years.

In 1983–86, the Philippines suffered a major political and economic crisis that led to the people power revolution against the Marcos rule. Heavy reliance on international borrowings to finance investment made the country vulnerable to external dependence. Once the political crisis became intense, international credit lines stopped.<sup>11</sup> With international lenders shying away from renewal of maturing loans, a major problem of liquidity arose. Export revenues were inadequate to deal with the payments deficit. New lines of credit could not be obtained as old lines were closed. Confidence was shaken and the payments crisis continued for a time. The government was implementing a structural adjustment programme dealing with trade and industrial liberalization as its centrepiece. But the payments crisis forced it to adopt exchange controls and temporarily to reverse the programme of reform.

The crisis of the 1980s was a severe experience for the Philippines. Output fell for two years in a row — an average decline of real GDP by 7.3% per year. Inflation reached a peak of 50% in 1984 and remained at two digits until the end of the decade. Periodic boom and bust characterized the macroeconomic picture, in part because the government had difficulty controlling the fiscal deficit. Market rigidities created by subsidies created an unstable macroeconomic climate.

In 1985, real GDP was 10% below that achieved in 1981. That year, the manufacturing, mining and construction sectors suffered a deep depression, all at 79% of their 1981 output. With a rising population, the economic cost to the nation in per capita terms was even larger,

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aggravated by the country's highly skewed income distribution. Agriculture, however, slowly improved over this period.

To restore macroeconomic stability, the principal priority was to reduce the fiscal deficit and to work out an external debt reduction programme with international lenders so that the payments burden could be reduced. The economic crisis of 1983–86 provided a powerful incentive to economic reform. As a result, the government was able to obtain strong political support for economic liberalization and for more prudent fiscal management, both of which were essential to economic recovery.

One important feature of the reforms was the need to strengthen the financial sector. The Philippine National Bank and the Development Bank of the Philippines were restructured by cleaning their balance sheets and transferring their non-performing assets to an agency that was designed to sell them. The central bank was reconstituted, with renewed capitalization, and the heavy foreign exchange losses on its past operations were transferred to the national government. A large block of the minority shares of the PNB was privatized and for a time helped to perk up activity on the stock exchange. Full privatization of the PNB is now being planned. The privatization of many government assets was undertaken not only to raise funds but to reduce waste in government.

### **Economic Crisis Continuing**

The Philippines has avoided the worst consequences of a full-scale crisis because it had strong macroeconomic fundamentals, including an exceptionally reformed financial sector at the beginning of the region-wide crisis. It will continue to remain in relatively better shape so long as these fundamentals are not damaged. Nevertheless, the economy remains vulnerable if the crisis continues much longer. As the crisis affects many countries, low demand will have a dampening effect on prospects for early recovery.

This vulnerability has already been felt. Only minimal growth is expected by the end of 1998,

at most 1% of GNP. Investment has been affected by the rise in interest rates. Banks have become defensive in their lending, tightening credit. The continued depreciation of the peso, along with that of other Asian currencies, has made interest rates less predictable, since these are tools for exchange rate determination. Yet, a major problem of overall economic management is how to stimulate generally depressed demand.

The other main challenge of economic management is how to preserve the gains from economic liberalization. The government is committed to further liberalization. It is now a case of not falling back in the face of a threat to the macroeconomic fundamentals. Any reversals of the structural reforms would have a devastating negative influence on future recovery. Sustaining a healthy macroeconomic framework is important, even at the cost of weak growth or even medium term stagnation. Prolonged stagnation, however, would threaten the social fabric.

A prolonged crisis could result from increased uncertainty in the world economy. So far, the Philippines has maintained good export performance. As a result, the trade balance has improved even in these difficult times. But export performance is vulnerable. The demand for electronics, the major export earner and provider of dynamic industrial employment in view of its labour-intensive character, could be easily affected by a downturn in world demand for computers. Although benefiting from a fall in commodity prices, such as energy products, the Philippines still is a primary exporter of processed metal ores and coconut oils. Thus, prosperity of its markets is essential to export growth and, in turn, to domestic growth.

Recent developments are not favourable. What was originally thought to be a regional crisis in mid-1997 has now become a phenomenon affecting a wider range of countries, beyond the Asian continent.

Japan's structural policy problems still need to be resolved. The core solution depends on Japan's political will to revitalize its banking sector and to stimulate internal demand. The

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collapse of Russia's economic programme has further weakened the international banking system, which is already reeling from the problems of Asia. The recent imposition of currency and capital controls in Malaysia has complicated the financial uncertainties further.

The capital markets are more nervous than a year before. The signals are transmitted through

the volatile behaviour of the stock and bond markets in Wall Street and Europe, not to mention the wild gyrations in the currency markets. Finally, countries in Latin America, which were initially net gainers in capital flows during the early Asian crisis, are now themselves experiencing the same fall in asset values, and their currencies are also under wide swings.

## NOTES

The author is particularly grateful for the database compiled at the Philippine Institute for Development Studies (PIDS), which summarized the essential statistics for this article. The websites of both the National Economic and Development Authority and the Central Bank were also helpful. The forum on current economic issues conducted by PIDS on 23 September 1998, which involved presentations by NEDA (Sec. Felipe Medalla), the Central Bank (Monetary Board Member Vicente Valdepenas), and the Department of Finance (Secretary Edgardo Espiritu) and discussions by a professional audience were helpful in smoothing a few rough edges of this article, a draft of which had already been completed.

1. New foreign direct investments amounted to US\$1,300 million in 1995 and net portfolio investments to US\$248 million. In the following year, net portfolio capital rose substantially to US\$2,179 million compared to US\$1,074 million of net foreign direct investments.
2. The concept of the real effective exchange rate takes into account the price of imports and exports and the price of home goods. Often, this problem of definition has led to a confused discussion of exchange rate policy issues between professionals in the central bank, on the one side, and their critics.
3. Thailand had an IMF package amounting to US\$17.2 billion; South Korea US\$57 billion; and Indonesia US\$40 billion.
4. The programme of raising minimum capitalization is being increased over a prescribed period of time, from 20% to 60%, depending on the class of banks, and to be undertaken in two equal rounds to be completed by the end of December 2000.
5. This property boom manifested itself especially in new industrial export zones, and demand for office and condominium buildings in the Makati-Ortigas area in Metro Manila and for housing.
6. Compared to Thailand at about this time, the loan exposure of Thai banks was about the same as that of Philippine banks, but Thai finance companies were highly exposed to about 24% of their portfolio. Philippine finance companies are not significantly engaged in real estate lending.
7. President Estrada, in his first state of the nation address, might have overdone it by stating that the government was "bankrupt" in July 1998. The government, of course, was in relatively good health under the circumstances, although it was facing a potential fiscal deficit that would stretch resources for an administration seeking to follow more prudent spending policies.
8. Recent reports on quarterly output estimated the first quarter growth to be 0.7% on a quarterly basis, so that the expected growth performance for the year will be barely positive.
9. The exception to this statement was the problem of a small commercial bank, insignificant in size to the total assets of the banking system. The problem of the bank was essentially mismanagement and poor lending policy, which involved its own directors.
10. The chairman of the stock exchange attributed the fall of equity values to lack of leadership in the new government, but then he withdrew his remarks within days. However, some analysts have again been making this commentary recently.
11. The period of the 1980s began with a declared intention to continue structural adjustment reforms, but the period was one of international financial turbulence especially following the international debt crisis precipitated by the Mexican debt problems.

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